Symposium on IFFs: Strengthening the Financial Integrity of the Climate Transition by Curbing Illicit Financial Flows

By:

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Introduction

Climate finance is critical in addressing climate change because of the large-scale investments required for the climate transition. Climate finance refers to local, national or transnational financing – drawn from public, private and alternative sources of financing that seek to support mitigation and adaptation actions that will address climate change. The United Nations Framework Convention on Climate Change, the Kyoto Protocol and the Paris Agreement call for financial assistance from Parties with more financial resources to those that are less endowed and more vulnerable to the adverse effects of climate change. Despite the gathering momentum when it comes to climate finance, developed nations have so far failed to meet their long-standing climate

pledges. Developed countries fall significantly short of their commitment to contribute $100 billion annually to support climate actions in developing nations. There remains a substantial financial gap in climate finance in Africa, yet climate disasters cost between 5 and 15% of the Gross Domestic Product (GDP) each year. According to the United Nations Economic Commission for Africa (ECA), the implementation of African Nationally Determined Contributions (NDCs) requires nearly $3 trillion, including about $2.5 trillion between 2020 and 2030.

The need to fast-track climate finance is urgent and undeniable. However, Parties should also take into account the question of financial integrity in the climate transition. Transparency International defines financial integrity as “a financial system that operates in a clean, transparent and accountable way”. Tax transparency, fiscal transparency, procurement and contract transparency, and beneficial ownership transparency are prerequisites to financial integrity.

A lack of financial integrity, such as corruption, illicit financial flows (IFFs), money laundering, embezzlement, opacity and more, is prevalent at all levels of financial and economic governance systems. It represents a severe drain on development financing, drives mistrust, inequality and abuse of power and impacts severely on public service delivery. The lack of financial integrity in the global system allows for billions of dollars in IFFs out of developing contexts, effectively cancelling out other development finance and efforts.

There is a significant risk that the projects, where much of this climate financing will need to be targeted, will be undermined by corruption - from bribery and kickbacks to fraud and embezzlement. The scale of the climate financing being provided and the speed with which the required projects need to be completed increases this threat. This results in transparency, due diligence and safeguarding being regarded as a secondary consideration.

Corruption, being a key source of IFFs, poses a significant risk to climate financing and threatens to undermine the global climate transition agenda. In Africa, the problem of IFFs continues to persist and needs to be urgently addressed.

Illicit Financial Flows in the African Context

According to the Economic Development Report in Africa, by the UN Conference on Trade and Development (UNCTAD), Africa loses about US$ 88.6 billion, 3.7 percent of its gross domestic product (GDP) annually in IFFs (IFFs). However, accurate data does not exist for all African countries and these estimates often exclude some forms of IFFs that are by nature secret and cannot be properly estimated. Therefore, grey areas exist in the identification and estimation of volumes of illicit flows.

IFFs in this context specifically refer to illegal movements of money or capital from one country to another. This movement is termed an 'illicit flow' when funds are illegally earned, transferred, or utilized across an international border.

The various means by which IFFs take place in Africa include abusive transfer pricing, trade mispricing, misinvoicing of services and intangibles and using unequal contracts, all for purposes of tax evasion, aggressive tax avoidance and illegal export of foreign exchange. IFFs are often driven by criminal activities with the purpose of keeping the transactions from the view of law enforcement agencies or revenue authorities. These criminal activities range from trafficking of people, drugs and arms to smuggling, as well as fraud in the financial sector, such as unauthorized or unsecured loans, money laundering, stock market manipulation and outright forgery.

IFFs have a significant and crippling effect on societies and economies. The COVID-19 pandemic, the increasing costs of climate change and environmental challenges have had a particularly devastating impact on developing economies, highlighting the critical need for addressing the financing gap. IFFs remain an impediment to the attainment of the 2030 Agenda and the African Union Agenda 2063 as they contribute to Africa's sustainable financing gap. IFFs drain resources that are needed to fulfil human rights and pursue sustainable development.

Using Kenya as a case study, IFFs have had adverse implications on the country's economic, social and developmental agenda. It is estimated that an average of KES 40 billion has been lost annually through IFFs as government, local firms and multinationals engage in fraudulent schemes to avoid tax payments. Tax evasion through IFFs occurs mainly through trade misinvoicing,

transfer pricing, trade-in contraband goods, corruption and trafficking of persons and drugs. In Kenya, IFFs also take the form of grand corruption scandals involving the transfer of illicit money by the ruling political elites since independence.

IFFs pose a threat to climate finance efforts of countries such as Kenya and undermine the climate transition agenda. To illustrate this, in 2008, as part of its renewable energy policy, Kenya created a state owned Geothermal Development Company. This company was 80% funded by donors, including the African Development Bank. The company was plagued by allegations of corruption and mismanagement, and its first project took ten years to implement. A whistle-blower reported that the CEO, General Manager, and five tender committee members inflated a contract to move equipment by US$19.5 million when the winning supplier had previously charged another client US$230,000 for similar work. This shows the dangers of allocating climate finance without proper transparency and accountability mechanisms as it would lead to corruption, which is a key source of IFFs.

Failure to address the rampant corruption in developing countries will make curbing of IFFs an impossible task and increase the risk of climate finance being diverted away from critical projects to private hands or secret tax havens by corrupt officials, criminal enterprises and illicit financiers. Climate finance transparency and accountability are critical so as not to fund corruption and exacerbate the existing issue of IFFs.

Strengthening the Financial Integrity of the Climate Transition

The call for major economies to shoulder their fair share of responsibility, particularly in the areas of loss and damage financing, debt restructuring and relief, and adaptation financing is getting louder. As catastrophic climate events are becoming more frequent, the need for substantial financial commitments to support vulnerable nations in their fight against climate change has reached a critical juncture. However, it is imperative to take into account the question of the financial integrity of the climate transition and ensure climate finance transparency and accountability.

Maximizing the effectiveness of climate finance must include steps to reduce the potential for corruption, as large influxes of resources coupled with an

imperative to spend can create conditions ripe for corruption. At the international level, the initiatives should aim at strengthening the integrity of the global financial system, a higher level of transparency, and tackling international corruption as well as the cross-border movement of illicit funds and recovering stolen assets.

The Report of the High-Level Panel on International Financing, Accountability, Transparency and Integrity for achieving the 2030 Agenda advocates for strengthened policy frameworks to promote financial integrity. Specifically, it calls for accountability by professionals who enable IFFs such as lawyers and accountants. It also calls for unified approaches at the national and global levels to exchange financial information to strengthen enforcement as a means of curbing IFFs arising from cross-border corruption.

Strengthening financial integrity in climate transition requires greater transparency, enhanced accountability and cooperation at national, regional and global levels in climate financing. Curbing IFFs from the proceeds of corruption requires an investment in transparency and integrity. This will help to maximize the impact of climate finance and maintain confidence in climate action and enable stakeholders to hold governments accountable for their commitments.

The Author

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